THE ASSISTANT SECRETARY OF THE NAVY
Research Development and Acquisition
1000 Navy Pentagon
Washington DC 20350-1000

DEC 2 3 2004

MEMORANDUM FOR DISTRIBUTION

Subj: CONTRACT PROFIT AND INCENTIVES ARRANGEMENTS

Ref: (a) ASN(RDA) memo dtd OCT 28,2003, Subj: Contracts Incentives, Profits and Fees

I issued reference (a) to provide guidance on the need to structure contract profit and incentive arrangements carefully to motivate contractor performance in ways that best meet DON objectives. My views on this subject have not changed -- I continue to expect employees negotiating contracts to apply the guidance in reference (a), as appropriate. However, based on industry inputs and a review conducted by DASN (ACQ) of award-fee provisions included in recent contracts and solicitations, I want to clarify a few elements of the guidance.

Reference (a) was not intended to create a cookbook approach for establishing contract profit and incentives arrangements. Although it identifies the kind of arrangements I believe will best serve the Navy's needs in most cases, my overarching intent is to have responsible officials craft arrangements that are based on in-depth understandings of (i) technical requirements and what the contractor will have to do to satisfy these requirements, (ii) the attendant technical risks, and (iii) the estimated costs and time required to complete performance. I further recognize that adopting appropriate contract profit and incentive arrangements is a necessary component, but not necessarily sufficient standing alone, to effectively ensure program success. In crafting arrangements, officials have flexibility to determine what will best motivate contractor performance and provide tools for program managers, considering the circumstances associated with individual contract actions. They must ensure, however, their decisions are knowledge-based and reflective of the overall intent of my guidance.

As stated in reference (a), there are circumstances where it is appropriate to use award-fee arrangements, and, in such cases, a significant portion of the evaluation of contractor performance should be based on objective, measurable criteria. This means that contractors, generally, should not be able to earn all of the available award-fee pool based solely on evaluation of subjective criteria. Conversely, in keeping with the philosophy underlying the use of award-fee contracts, it also means contractors' ability to earn any fee should not hinge solely on evaluation of objective criteria. Therefore, if use of an award-fee arrangement is appropriate, a portion of the award-fee pool should be available for the contractor to earn based on objective criteria and a portion on the basis of subjective criteria.

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I feel strongly that contractors should have to earn any fees or profits they receive based on their performance. Nonetheless, in a number of cases, I recognize it may be appropriate to include modest minimum fees in cost-plus-incentive fee contracts or base fees in award-fee contracts.

Award fee provisions included in recent contracts and solicitations have been structured, for the most part, consistent with my guidance to base the evaluation of the contractor's performance on a combination of subjective and objective criteria. In some cases, however, the evaluation criteria have been identified in ways that were not completely clear'with respect to when specific objective factors would be considered or how various objective and subjective factors relate to each other. This lack of clarity has confused contractors 'and led them to believe it would be almost impossible to earn any award fee even if their performance were satisfactory. Since contractors read award fee provisions very carefully, it is incumbent on our responsible personnel to ensure these provisions clearly explain how the contractors' performance will be evaluated. This does not mean that complex scoring schemes are required. In fact, simpler may often be better, provided a clear explanation of the Government's planned approach is included. As mentioned, emphasis should be placed on explaining the relationship between various evaluation factors, particularly if some are objective and some are subjective. Further, if some evaluation factors will only apply to certain award fee periods, care should be taken to ensure that the applicability of these factors to specific award fee periods is clearly explained. Incentives should be based on actual, not projected, performance.

John J. Young, Jr.

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